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Illinois Bell Telephone Company	)	
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Application for Review of Alternative	)	Docket No. 98-0252
Regulation Plan	)	
	)	
Petition to Rebalance Illinois Bell	)	
Telephone Company's Carrier Access and	)	Docket No. 98-0335
Network Access Line Rates	)	
	)	
Citizens Utility Board and People of the	)	
State of Illinois, ex rel. James E. Ryan,	)	
Attorney General of the State of Illinois,	)	
Complainants	)	
	)	
vs.	)	Docket No. 00-0764
	)	
Illinois Bell Telephone Company d/b/a	)	
Ameritech Illinois,	)	(consolidated)
Respondent	)	

**INITIAL BRIEF OF THE PEOPLE OF THE STATE OF ILLINOIS**

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## TABLE OF CONTENTS

Introduction .....	1
I. Summary of the Case .....	2
II. Review of the Alternative Regulation Plan	
A. Scope of Review in this Proceeding: The Commission Expected This Review to Be Comprehensive, and To Enable It To Correct Problems, Errors and Deficiencies of the Plan. ....	5
B. Commission Goals for the Plan .....	8
C. Issues Specified in the 1994 Order .....	9
1. Whether the Inflation Index and the Manner in Which it Is Applied Provide an Adequate Reflection of Economy-wide Inflation .....	9
2. An Assessment of Productivity Gains for the Economy as a Whole, for the Telecommunications Industry to the Extent Data Are Available, and for Illinois Bell During the Period That the Alternative Regulatory Framework Has Been in Place, and Whether the Adopted General Adjustment Factor Should Be Modified. ....	10
3. Whether the Adopted Monitoring and Reporting Requirements Should Be Retained or Adjusted. ....	13
4. The Extent to Which Illinois Bell Has Modernized its Network, and Additional Modernization Plans for the Future. ....	14
5. A Listing of All Services in Each Basket and a Report of the Cumulative Percentage Changes in Prices for Each Service During the Period the Mechanism Has Been in Effect. ....	17
6. A Listing of Services Which Have Been Withdrawn During the Period. ....	18
7. A Listing of All Services Which Have Been Reclassified as Competitive or Noncompetitive During the Period. ....	19
8. A Summary of New Services Which Have Been Introduced During the Period. ....	20

9.	Information Regarding Any Changes in Universal Service Levels in Illinois Bell's Service Territory During the Price Cap Period. ....	21
10.	Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals. ....	22
D.	Meeting the Statutory Criteria .....	22
1	The Current Alternative Regulation Plan Is Not In The Public Interest. . The Alternative Regulation Plan Has Not Resulted in Fair, Just and Reasonable Rates for Non-Competitive or Competitive Services, in Violation of Sections 13-506.1(b)(2) As Well As Sections 13-506.1(a)(6) and 13-103(a) and Other revisions of the PUA. ....	23 24
2.	The Changes in Technology and Industry Structure Anticipated by the Alternative Regulation Plan Have Not Occurred, and the Plan's Reliance on Those Changes Has Led to Unjust Results. ....	30
a.	The Competitive Changes the Commission Anticipated Have Not Occurred. ....	31
b.	The Plan Has Not Led IBT to Respond Appropriately to Changes in Technology. ....	35
3.	Ratepayers have not benefitted from efficiency gains, productivity and cost savings arising from regulatory change. ....	37
4.	Alternative Regulation Can Only Be Continued If it Constitutes a More Appropriate Form of Regulation Based on the Commission's Overall Consideration of the Policy Goals Set Forth in Section 13-103 and Section 13-506.1. ....	37
5.	The law requires that an alternative regulation plan specifically identify how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change .....	39
6.	Alternative Regulation Has Failed to Maintain the Quality and Availability of Service in Violation of Sections 13-506.1(b)(6) and 13-103(c) .....	39
7.	The Alternative Regulation Plan Has Not Complied With The Statutory Requirement That The Plan Not Unduly or Unreasonably Prejudice or Disadvantage Any Particular Customer Class, Including	

Telecommunications Carriers Because IBT Has Abused The Competitive  
 Reclassification Process and Basket Structure, Has Used the New Services  
 Provision to Raise Basic Residential Rates and Has Not Reflected Cost  
 Savings In the Residential NAL Rate. .... 48

8. The Plan Has Not Furthered the Policy Goals Specified in Section 13-  
 506.1(a) and 13-103. .... 50

### III. Going Forward Proposal

- A If the Price Cap Index Is Retained, Adjustments Must Be Made to Existing  
 Components. .... 51

1. The "X" Factor in the Price Index Needs To Be Increased to 6.5% to  
 More Accurately Reflect IBT's Cost Savings. .... 52
2. If the Commission Does Not Adopt a 6.5% X Factor, it Should Explicitly  
 Include a Consumer Productivity Dividend in the X Factor it Does Adopt. .... 55
3. Price Cap Index Plan Must Retain the Current Basket Structure and 2%  
 Pricing Flexibility to Insure Just and Reasonable Rates, Fairness to All  
 Customer Classes and to Avoid Ramsey Pricing. .... 57
4. The Cap on Residential Basic Service Should Be Continued. .... 59
5. The Commission Should Reject IBT's Request to Exclude Certain Non-  
 Competitive Services from the Price Cap. .... 61
6. The PCI and API Should Be Reset to 100 .... 62
7. Only Services That Have Not Been Previously Offered, and Not Services  
 That Are Merely Repriced, Should Be Considered "New Services" under  
 the Plan. .... 63
8. The Exogenous Factor in the Price Cap Index Should Not Be Changed. .... 65

- B. New Components

1. The Plan's Incentives to Prematurely Reclassify Services as Competitive,  
 and the Resulting Rate Increases, Litigation and Reclassification Back to  
 Non-competitive Status Should Be Corrected in this Docket .... 66
2. A Merger Savings Adjustment Factor Should Be Added To the Price Cap  
 Index to Capture Merger Savings Pending Audit of Annual Savings. .... 68

- C. Rate Reinitialization Is Required To Reduce Rates to Just and Reasonable Levels and to Mimic The Effect Of Competitive Markets. . . . . 69
- D. An Earnings Sharing Provision Can Correct Misspecifications of the PCI and Remove or Moderate the Financial Incentives to Sacrifice Service Quality for Short Term Profit and Improperly Reclassify Services as Competitive By Subjecting Earnings to Commission Review. . . . . 73
- C. The Commission Should Reinitialize Rates and Substantially Adopt the Modifications to the Price Cap Plan Recommended Herein (Including the Service Quality Safeguards Discussed Below), or in the alternative, Return IBT to Rate of Return Regulation. . . . . 75

#### IV. Service Quality - Going Forward

- A. Legal Standards . . . . . 77
- B. Existing and Proposed Measures and Benchmarks. . . . . 77
  - 1. Is Necessary to Provide Benchmarks for POTS Installation and POTS Repair Because POTS Is an Essential Service Which Should Be Readily and Reliably Available to Illinois Citizens. . . . . 79
    - a. POTS Installation Measures . . . . . 80
    - b. POTS Repair Measures . . . . . 82
  - 2. The Other Major Category of Measures Is Intended to Insure That Customers Can Contact the Company Without Undue Delay. . . . . 85
- C. Existing and Proposed Penalty Structures . . . . . 87
  - 1. The Existing Service Quality Penalty Structure Has Been Ineffective in Overcoming the Perverse Incentives Inherent in Price Cap Regulation to Cut Costs While Allowing Service Quality for Inelastic Services to Deteriorate. . . . . 87
  - 2. The Service Quality Adjustment Should Be Substantial Enough to Provide Adequate Incentives to Maintain And/or Improve Service Quality and Should Be Administered Outside a Price Cap Index. . . . . 88
  - 3. If the Service Quality Adjustment Is Made Within the Price Cap, the Commission must Insure That the Adjustment Is Equivalent to That Proposed for Non-PCI Adjustment. . . . . 91

D.	In Addition to a Service Quality Adjustment, Whether Within or Outside the PCI, Consumers Affected by Certain Service Quality Problems Should Receive Direct Compensation. ....	91
E.	Summary .....	94
V.	Revenue Requirement Analysis .....	94
VI.	Cost of Service .....	
VII.	Rate Design .....	
VIII.	CUB/AG Complaint .....	
IX.	Conclusion .....	

## **Introduction**

This is a proceeding to reconsider the rate experiment for Illinois Bell Telephone Company's ("IBT") customers known as "alternative regulation." The Commission initiated this experiment more than six years ago in an attempt to fashion a form of regulation more appropriately suited for current technological, economic and market conditions in the telecommunications industry. The specific purpose of this review is to evaluate the relative success of the alternative regulation plan over the past six and a half years in facilitating the General Assembly's statutory goals for such plans.

Unfortunately, the People must conclude that based on the evidence presented in this case, and despite the Commission's best intentions, the alternative regulation plan established in Docket No. 92-0448/93-0239 ("Alt. Reg. Order") has not lived up to expectations. Where the Commission sought to foster a transition to competition for local exchange service, competition in that market is no broader than it was when the plan was first implemented. Where the Commission resolved to create incentives for the Company to innovate and expand services, service quality has actually declined and innovation has not developed. Where the Commission intended that the Company's customers benefit from its increasing productivity, the Company has used the plan to generate excessive earnings at ratepayer expense. Most important, where the Commission hoped to establish "a more appropriate form of regulation" to further the General Assembly's progressive policies with respect to telecommunications services, the alternative regulation plan has fallen short of this goal in numerous respects.

In shaping its analysis of specific issues, the People urge the Commission not to lose sight of the fact that alternative regulation is a ratemaking tool and this is a ratemaking

proceeding. The General Assembly granted the Commission authority to approve alternative forms of regulation specifically in connection with its duty to set just and reasonable rates: “Notwithstanding any of the ratemaking provisions of this Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services...” 220 ILCS 5/13-506.1(a) (emphasis added). No matter how technical the subject under consideration in this proceeding, the goal of just and reasonable rates should remain paramount.

Accordingly, this brief will particularly focus upon whether or not the plan has provided just and reasonable rates for the Company’s customers. Regardless of the subject matter under consideration, this must be the guiding principle of any analysis under the Public Utilities Act. Ultimately, the success of any regulatory scheme must be evaluated on the basis of whether or not it has accomplished this most fundamental regulatory goal.

## **I. Summary of the Case**

This case is a review of the performance of the alternative regulation plan adopted upon the petition of Illinois Bell Telephone Company (IBT) almost seven years ago and the relative success of that plan in accomplishing the Commission’s statutory and regulatory goals. Consistent with IBT’s request, the Commission adopted a “pure price cap” plan in ICC Docket 92-0448 which was designed (1) to recognize that telecommunications is a cost declining industry; (2) to capture the cost decreases for customers in annual rate adjustments; (3) to maintain service quality; and (4) to give IBT the opportunity to earn a reasonable return without the constraints of rate of return regulation. Order, ICC Docket 92-0448/93- 0239 (Oct. 11, 1994)(hereafter “Alt. Reg. Order).

This review docket demonstrates that although IBT has implemented those rate adjustments and decreases mandated by the plan, weaknesses in the plan have diminished expected ratepayer benefits. The premature reclassification of non-competitive services as competitive, the removal of those services from the price cap plan and increases the rates of the newly reclassified services have shrunk the scope of the plan and prevented rate decreases from keeping pace with the company's decreasing cost of service. The record also shows that while IBT has managed to meet minimum service quality standards in some areas, it has allowed service quality to deteriorate to crisis levels in others. Improvements in the company's quality of service over the past six and a half years have become the exception, not the rule.

Evidence that IBT has experienced substantial decreases in its cost of service over the course of the plan is clear. Regardless of whether one considers IBT's analysis, Staff's analysis or GCI's analysis, IBT's rates -- even after the rate decreases mandated by the plan -- produce revenues two to three times greater than the returns approved by this Commission for IBT in 1994, the returns recommended as reasonable by experts in this docket, and the returns allowed other Illinois utilities and incumbent local exchange carriers since October, 1994.<sup>1</sup>; see also GCI Ex. 6.2 at 51. Although the Commission may have intended to allow IBT to benefit from efficiencies greater than those the productivity index anticipated, the magnitude of IBT's current revenues shows that the productivity factor was not set appropriately. To remedy this problem, the Commission should reduce IBT's rates to reasonable levels and adopt a productivity or "X" factor that will more accurately reflect the cost reductions prevalent in the telecommunications industry and achieved by IBT. As detailed below, additional changes to the current alternative

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<sup>1</sup> IBT was allowed a 9.64% return on rate base in 1994, Alt Reg Order at 175. GTE was allowed a 10.59 overall return on rate base in 1994. Order at 105, ICC Docket 93-0301/94-0041.

regulation plan are required in order to bring the plan into compliance with statutory and regulatory requirements established in 13-506.1 of the Public Utilities Act.

This docket also presents two other petitions for the Commission's consideration. First, IBT's "rate rebalancing" petition (Docket No. 98-0335) requests that the Commission restructure its rates so that the residential network access line charge, its most inelastic charge, is increased by \$2.00 (or 78.43 %, 36.17%, and 22.22% for access areas A, B, and C respectively) while rates for timed Band B usage and certain vertical services are reduced. Although IBT argues that these increases are necessary to "rebalance" rates, the Commission explicitly rejected the position that Ameritech could increase other rates to offset the switched access rate reductions ordered by the Commission.<sup>2</sup> Even if such rebalancing were permitted, IBT has proposed increasing rates by more than access rates were decreased. The company is seeking an additional \$43 million to "rebalance" its residential revenues, despite the fact that switched access rates were reduced by only \$33 million.<sup>3</sup>

The cost of service study produced by IBT to justify these rate changes has been rejected by both Staff and GCI witnesses as not reliable or accurate. GCI witness Dunkel has demonstrated that even with a \$1.30 reduction in the network access lines for both residential and business customers, the NAL rate would still cover all network access line costs, including all loop costs. GCI Ex. 8.0 at 12-14 & GCI Ex. 8.2, 8.3. IBT's request to "rebalance" rates should be rejected, and the rate reductions recommended by GCI witness Dunkel should be adopted.

The People of the State of Illinois by James Ryan, Attorney General, and the Citizens

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<sup>2</sup> See Staff Ex. 14.0P at 7-8.

<sup>3</sup> AT&T Ex. 1.0 at 9.

Utility Board also filed a petition to adjust rates ("CUB/AG Complaint," Docket No. 00-0764) which was consolidated with this docket. This petition requests that IBT's current rates be adjusted to establish them at just and reasonable levels, as required by sections 9-250, 13-505 and 13-506.1(b)(2) & (e) of the Public Utilities Act. 220 ILCS 5/9-250, 13-505, 13-506.1(b)(2) & (e). IBT's extremely high return on rate base, as documented by accounting data presented by GCI witness Ralph Smith, Staff witnesses and IBT witness Timothy Dominak, demonstrate that the price cap plan has failed to capture a reasonable portion of the cost savings which accrued to IBT during the operation of the plan. The resulting rates are unfair to consumers, are unjust and unreasonable and are therefore unlawful under the PUA. Accordingly, the CUB/AG Complaint should be granted, and IBT's rates should be reduced by \$956 million, consistent with the rate design offered by GCI witness Dunkel. This reduction should occur regardless of the form of regulation ultimately adopted for IBT.

## **II. Review of the Alternative Regulation Plan**

### **A. Scope of Review in this Proceeding: The Commission Expected This Review to Be Comprehensive, and To Enable It To Correct Problems, Errors and Deficiencies of the Plan.**

In adopting an alternative regulation plan for IBT, the Commission repeatedly recognized that it was entering uncharted territory and that it could not accurately predict whether the plan would ultimately meet its statutory and regulatory goals. For example, the Commission observed that "...any alternative form of regulation must be carefully monitored to ensure that its intended effects are being realized." Alt. Reg. Order at 20. In ordering IBT to report certain data, the Commission expected that such reporting "may provide useful evaluative information. For example, unusually high reported rates of return, particularly in the face of accelerated

depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective.” Id. at 92.

The Commission pointedly left open future consideration of earning sharing, stating that “the initial alternative regulatory plan” does not preclude future review of revenues or revenue sharing. Alt. Reg. Order at 51. At other points the Commission emphasized that the Order was its “first implementation of price regulation” and that it would use results from other jurisdictions “as a frame of reference for the analysis of results in Illinois, and for the identification of any emerging or potential problem areas.” Id. at 35.

Consistent with its view that the alternative regulation plan was new and untested, the Commission ordered the Company “to submit an application for review of the adopted alternative regulatory mechanism” on March 31, 1998. The Commission planned this review to consider the results of IBT’s alternative regulation trial after five years. Alt Reg Order at 94 & App. A at 10. Under section 13-506.1(e) of the PUA, the Commission may review an existing alternative regulation plan, upon its own motion or upon a petition filed by the telecommunications carrier, to insure that the plan has satisfied and will continue to satisfy the conditions in Section 13-506.1(b). The Commission designated nine broad criteria for evaluation, chosen to assess the success of the plan and concluded that its review should address “[w]hether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.” Alt. Reg. Order at 95. Consequently, the scope of review in this docket is not limited to the nine subject areas specified in the alternative regulation order, but also includes the Commission’s consideration of the ultimate issue: whether the current plan has met the requirements of Section 13-506.1, and whether it can meet those

requirements on a going-forward basis.

GCI witness Charlotte TerKeurst agreed that an exhaustive review was necessary, testifying that “all issues whose consideration would have been appropriate during the 1993/94 proceeding may appropriately be considered in this review proceeding.” GCI Ex. 1.0 at 10. She further testified that both non-competitive and competitive rates and revenues need to be subject to review because in the absence of alternative regulation, both non-competitive and competitive rates and revenues would be included in a rate analysis. GCI Ex. 11.0 at 25-26. Therefore, in order to determine whether the current alternative regulation plan satisfies Section 13-506.1(b), and whether the rates it produces are fair, just and reasonable, all of IBT’s rates, revenues and expenses must be considered.

Additionally, the CUB/AG Complaint, which is consolidated with this docket, questions whether the current plan produces just and reasonable rates and complies with the requirements of section 13-506.1(b). See CUB/AG Complaint, Count II. The CUB/AG Complaint specifically alleges that both non-competitive and competitive local exchange rates are unjust and unreasonable under sections 9-250, 10-108, 13-504 and 13-505 of the PUA. See CUB/AG Complaint, Count I.

#### **B. Commission Goals for the Plan**

The Alt. Reg. Order established the Commission’s intention “...to regulate IBT in a manner which will be viable over the long term and produce benefits for ratepayers, IBT and the State of Illinois.” Alt. Reg. Order at 3. The Commission’s adoption of a new regulatory scheme was motivated by its assessment of the changes anticipated in telecommunications technology, and its assumption that “...competition is likely to increase in the future and the regulatory policies of this State should be directed toward a successful transition to a more competitive

environment.” Id. at 19; see also id. at 3.

In order to deal with the uncertainties of the marketplace and to comply with statutory requirements, the Commission used rate of return principles to set IBT’s rates at just and reasonable levels at the outset of the plan. It intended that a strategically-designed price index formula would provide just and reasonable rates through the operation of the plan. It also intended that the “potential financial impact” of the service quality factor would provide a “considerable incentive to maintain service quality.” Alt. Reg. Plan at 186, 190.

The 1994 decision was realistic about the Commission’s limited ability to accurately predict exactly what type of plan would best promote a transition to a competitive marketplace while protecting captive ratepayers. The Alt. Reg. Order cautioned that:

[the plan involves] many unknowns. Any decision that the Commission makes in this docket will carry with it some uncertainty. The Commission’s goal in this proceeding is to weigh all of the risks and to proceed in a manner that balances all of the interests at stake, within the confines of the Act.

Id. at 3-4; see also id. at 13. The Commission therefore scheduled a five year review of the alternative regulation experiment. It was predicated on the novelty of the plan and was designed to enable the Commission to react to developments in the telecommunications market and adjust the plan as time and circumstances dictated. See, e.g., Alt. Reg. Order at 3-4, 13, 19,

### **C. Issues Specified in the 1994 Order**

The Alt. Reg. Order specified 10 items which it ordered IBT to address in its application for review of the plan. Some of the items are a simple listing of changes occurring during the plan (e.g., 5,6,7, 8), while others are more substantive, such as whether the adjustment factor in the price cap index should be modified and whether the plan has met each of the established

statutory and regulatory goals (3,10). See Alt. Reg. Order at 95, 179-192.

Each item identified in this section of the Alt. Reg. Order will be discussed below. Some issues will be more fully addressed in the following sections of this brief, including “Meeting Statutory Requirements” and “Going Forward Proposal”.

**1. Whether the Inflation Index and the Manner in Which it Is Applied Provide an Adequate Reflection of Economy-wide Inflation.**

The measure of inflation in the price cap index is the Gross Domestic Producer Price Index (“GDPPI”). GCI witness Lee Selwyn proposed that the Commission adopt the chain-weighted GDPPI measure in the price index formula, GCI Ex. 3.0 at 12-14. Staff and Ameritech witnesses agreed. See Staff Ex. 2.0 at 7; Am. Ill. Ex. 2.2 at 2.

The manner in which the GDPPI has been applied has raised some issues, however. The BEA restates the GDPPI periodically, and if the effect of that restatement is not reflected in the price cap formula, IBT can double count a portion of inflationary change to its benefit. Staff Ex. 13.0 at 18. Because these restatements can have a “drastic effect on GDPPI data and their consistency from year to year.” *Id.* at 19, the Commission should make appropriate adjustments to the annual rate filing process to correct this problem and insure consistency.

Annual rate filings scheduled to correspond to the August GDPPI restatement would enable the Commission to accommodate whatever revisions were made to the GDPPI as part of the annual rate filing. The People recommend that the annual rate filing be scheduled for September 30 of each year so that the Commission and the parties can incorporate the effect of the most recent revisions to the GDPPI in the annual rate filing.

**2. An Assessment of Productivity Gains for the Economy as a Whole, for the Telecommunications Industry to the Extent Data Are Available, and for Illinois Bell During the Period That the Alternative Regulatory Framework Has Been in Place, and Whether the Adopted General Adjustment Factor Should Be Modified.**

This issue requires an assessment of the “X” factor, or the “general adjustment factor”, and whether it should be modified on a going-forward basis. Although this issue will be discussed again in Section III, “Going Forward Proposal,” an assessment of the X factor is necessary here as well.

In establishing the price index, the Commission sought to capture the “competitive outcome” in which industry productivity improvements and cost conditions are flowed through to consumer prices. GCI Ex. 3.0 at 6. It adopted a 4.3% X factor, consisting of a 3.3% productivity factor and a 1% consumer dividend, which is subtracted from the GDPPI inflation rate to determine the percentage amount of aggregate rate increases or decreases under the price index plan, subject to service quality performance and exogenous factor adjustments. The 3.3% productivity factor was intended to mirror the “historical differentials between economy-wide and Illinois Bell input prices.” *Id.* at 39. The 1% consumer dividend was based on the Commission’s expectation that IBT would exceed the 3.3% productivity factor, and that consumers should benefit by adjusting IBT’s rates by this additional 1%. Alt. Reg. Order at 39.

The Commission recognized the importance of setting the adjustment factor appropriately, because underestimating the factor would result in excessive rates. Alt. Reg. Order at 37. The Commission also noted that the productivity factor it adopted was “consistent with the methodology used by the FCC and other jurisdictions.” *Id.* at 38. This was important, the Commission said, so “we can assure ourselves that the plan we adopt can incorporate more readily any further developments in that theory, and the results from price regulation in other

jurisdictions can, when appropriate, be used as a frame of reference for the analysis of results in Illinois, and for the identification of any emerging or potential problem areas.” Id. at 35.

GCI witness Dr. Lee Selwyn concluded that the X factor as applied failed to capture a reasonable portion of IBT’s productivity. GCI Ex. 3.0 at 22-23. To test the effectiveness of the X factor, Dr. Selwyn calculated what productivity factor would have resulted in IBT earning the authorized rate of return of 11.36%. His “implicit X-factor” analysis showed that IBT’s actual productivity during the course of the plan was 11.06%. GCI Ex. 3.0 at 26. This shows that the 4.3% offset has been unreasonably low and that ratepayers have not received a reasonable portion of the productivity savings achieved during the course of the plan. GCI Ex. 3.0 at 26 and GCI Ex. 13 at 18.

Dr. Selwyn testified that the insufficiency of the 4.3% X factor is also demonstrated by IBT’s reported earnings of 19.15% for intrastate operations (later reduced to 18.82%, Am. Ill. Ex. 7.3 at 5) and 23.89% for total company operations for 1999. GCI Ex. 3.0 at 16. IBT’s and Ameritech’s reported earnings, compared with FCC ARMIS data for the other Bell Operating Companies, or BOCs, show the great disparity between Illinois Bell, Ameritech and other BOCs. Although IBT only produced its intrastate return on investment (or rate base) and Ameritech’s overall return on equity (GCI Ex. 1.2, IBT’s Response to AG DR 1.1), it is clear that both IBT and Ameritech have received a higher return than the other BOCs after alternative regulation took effect:

	Illinois Bell Return on Rate Base	Ameritech Return on Equity	BOCs excluding Ameritech Return on Equity
1995	9.43%	15.01%	12.80%
1996	10.53%	14.02%	16.42%

1997	14.25%	16.67%	12.11%
1998	13.92%	18.82%	15.63%
1999	19.15%	23.89%	16.45%

GCI Ex. 1.2 & 11.1. IBT's return on rate base is almost as high or higher than the BOCs overall return on equity<sup>4</sup>, and Ameritech's own reported return on equity is several hundred basis points higher than the other BOCs return in every year except 1996. These notably high returns on both Illinois rate base and Ameritech stockholder equity are irrefutably strong evidence that the X factor has been unreasonably low and that ratepayers have been paying excessive rates as a result. See Alt. Reg. Order at 37 (underestimated X factor can lead to excessive rates).

In adopting a pure price cap plan, the Commission recognized that adjustments might become necessary in light of the actual operation of the plan, and expected to incorporate the results and use the analysis from other jurisdictions using price cap regulation. Alt. Reg. Order at 35, 38. As will be discussed more fully below, the FCC has adopted a 6.5% adjustment factor, called a "rate reduction factor" as a result of the "CALLS" settlement proposed by the BOCs, including IBT's parent SBC. GCI Ex. 13.0 at 14. Although this 6.5% adjustment factor does not reflect all of the annual cost savings identified in this docket, it is a more accurate adjustment that will return a reasonable amount of savings to consumers while preserving the efficiency incentives that are part of the price cap plan.

The implicit X factor analysis, IBT's extraordinarily high rate of return on rate base, and the fact that IBT, Ameritech and SBC proposed a 6.5% rate reduction adjustment in the federal

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<sup>4</sup> Equity is the most expensive component of a company's capital structure, and is always higher than the overall cost of capital, which includes lower cost debt. See, e.g., Am. III Ex. 6.0 at Sch 13; Staff Ex. 11.0, Sch. 11.11.

jurisdiction all demonstrate that the 4.3% X factor was understated and must be adjusted upward.

### **3. Whether the Adopted Monitoring and Reporting Requirements Should Be Retained or Adjusted.**

The Commission required IBT to file certain financial and operational reports during the course of the price cap plan because it wanted to track the operation of the plan. Alt. Reg. Order at 92. The reporting information received by the Commission each year and in the annual rate filing continues to be necessary to enable the Commission to monitor that the plan is being properly applied and that the intended benefits are realized. GCI Ex. 1.0 at 85.

### **4. The Extent to Which Illinois Bell Has Modernized its Network, and Additional Modernization Plans for the Future.**

Because an inadequate alternative regulation scheme can incent the Company to reduce costs and let service quality deteriorate, network investment safeguards are necessary to ensure adequate and continuing investment in network infrastructure. GCI Ex. 1.0 at 71-72; Alt. Reg. Order at 58. Although IBT reported that it spent \$3.7 billion on infrastructure investments since the inception of price cap regulation, Am.III. Ex. 1.1, Sch. 3, it is apparent that its network infrastructure investment has not been effective in maintaining high quality telecommunications service for Illinois residents. GCI Ex. 1.0 at 73.

IBT reported spending \$3.7 billion 1995 to 1999. Nevertheless, IBT has not maintained adequate network access facilities or reliability during the plan. In the latter half of 2000 there were insufficient network access lines available for installation, resulting in extensive delays in the installation of "Plain Old Telephone Service" or POTS. GCI Ex. 1.0 at 73. During this

period, consumers waited weeks and even months for installation of a simple telephone line or repair in some areas of the state. GCI Ex. 2.0 at 14. The number of out of service complaints also increased, and IBT failed to return a greater and greater number of customers to service within the 24 hour benchmark. Id. at 10.

SBC's chairman, Edward Whitacre, publicly attributed these service quality problems to inadequate investment in infrastructure. GCI Ex. 11.0 at 68-69. Similarly, GCI witness Charlotte TerKeurst determined that investment in network access facilities has been inadequate to keep up with demand. GCI Ex. 1.0 at 73. In addition, the Company has also cut corners by using pair gain arrangements whereby up to 12 network access lines are derived from a single copper loop. GCI Ex. 1.0 at 74. Use of pair gain technology degrades service by slowing down data transmission time to the extent that ordinary internet use becomes unacceptably slow (from an expected 56.5 kilobits per second to 14.4 kilobits per second). Id. IBT's position that consumers who want faster data transmission speeds can order DSL or ADSL service is unacceptable (1) because it attempts to justify a degradation of service by (2) putting an additional expense and burden on consumers in order to obtain the quality of service they received prior to the extensive use of pair gain technology (3) in a manner that could potentially benefit Ameritech's sister company which offers DSL service on an unregulated basis.

Another way to assess the adequacy of Illinois Bell's investment level is to compare it to IBT's claimed depreciation expense. IBT took a total of \$3.4 billion in depreciation accruals from 1995 to 1999. City Ex. 1.0 at 38. Depreciation represents the amount of plant that was used or required replacement in a given year. GCI Ex. 8.0 at 90-91. When rates are sufficient to cover the Company's depreciation expense, ratepayers are providing the funds to replace the investment being used. Id. Therefore, the size of IBT's investment is not significantly greater

than would be expected simply to replace outmoded plant.

Despite IBT's reported \$3.7 billion infrastructure investment, consumer services have been disrupted by service quality degradation. These facts can lead the Commission to only one conclusion: existing network investment requirements and reporting have not only failed to produce an advanced telecommunications network, but have led to a serious deterioration of service quality in terms of installation times, percent out of service, repair times and transmission speeds.

Obviously, any network modernization requirements should meet the requirements recently imposed by the Commission's Merger Order in ICC Docket 98-0555. Merger Order at 240. But the Commission should also take this opportunity to reconsider the network modernization analysis contained in its original Alt. Reg. Order. Alt. Reg. Order at 191-192. The Alt. Reg. Order was skeptical of the importance of the Company's investment commitment to the overall alternative regulation plan, calling it "...clearly subordinate to the incentive effects of price regulation and the benefits of market-driven network deployment." That order chided the Attorney General and other parties for having attached "...far more significance...to the Company's \$3 billion commitment than is warranted." Alt. Reg. Order at 192.

Events over the past six and a half years, however, have proven that the Attorney General's concern was well-founded. Evidence in this docket demonstrates that IBT's inadequate network investment has had a major impact on the ability of the plan to fulfill the legislature's statutory goals. It has even affected IBT's plans for DSL expansion, as the Company was recently forced to admit to the investment community. GCI and City Ex. 11.0 at 68-69, footnote 73. This deficiency has been one of the primary reasons for the Company's inability to comply with the Commission's installation requirements. GCI Ex. 1.0 at 73. It has

also served to undermine the Company's ability to provide advanced Internet services. GCI Ex. 1.0 at 74-76.

Especially in view of IBT's well-documented service quality problems, the Commission should not weaken reporting requirements on infrastructure investment. The increased reporting detail the Commission's Merger Order directed IBT to provide should also be filed with the Company's annual rate filings. GCI Ex. 1.0 at 84. The Commission should rely upon the annual infrastructure investment reports ordered in the merger docket to make formal determinations, as necessary, on whether the existing infrastructure investment should be increased to keep any alternative regulation plan in compliance with statutory requirements. See generally, GCI Ex. 1.0 at 74-84.

**5. A Listing of All Services in Each Basket and a Report of the Cumulative Percentage Changes in Prices for Each Service During the Period the Mechanism Has Been in Effect.**

In response to this issue, IBT listed cumulative price percentage changes for each service basket as Schedule 1 to Am.III. Ex. 1.0. The listing demonstrates that in the six and a half years that IBT has operated under alternative regulation, the Company has made no reductions to the residential network access line ("NAL") charge, the most basic and inelastic element of local exchange service. The network access line charge is a prerequisite to receiving any other landline telecommunications service, including long distance, and is paid by customers every month, regardless of whether or not they make calls on the network. By granting IBT the flexibility to decide how rate reductions would be allocated among various services, the plan allowed the Company to ensure that the most inelastic portion of the local phone bill never decreased -- a regressive result that siphoned most of the benefits of alternative regulation to

high-volume customers. Not only is this pricing structure inequitable, it runs counter to the Commission's policy to guard against "Ramsey pricing." See Alt. Reg. Order at 70.

The schedule also shows that during the plan, IBT made only modest reductions to those services in the residential basket most often used by residential customers: the Company reduced usage rates for band A, where customers place the most local calls, by only 3.85%. Less-frequently placed band B calls enjoyed a higher discount, between 21 and 33%. The major reductions, ranging from 42% to 297%, resulted from increasing the residential volume discount, which is based on total usage. Am. Ill. Ex. 1.0, Sch. 1. Therefore, IBT linked rate reductions to increased use of its system, in a "more you pay, more you save," scheme which drastically limited rate reductions to low or moderate use customers.

The Price Cap Plan included certain pricing constraints such as limiting pricing flexibility to 2% of the API and requiring rate reductions for each of four service baskets in an effort to insure that all classes of customers benefitted from the anticipated rate reductions. Alt. Reg. Order at 69-70; 220 ILCS 5/13-506.1(b)(7). IBT's failure to reduce the NAL rate and Band A usage and its use of volume discounts to implement rate reductions under the plan show that the plan failed to benefit all classes of customers and requires that the plan be modified on a forward going basis. These modifications are discussed in more detail below.

#### **6. A Listing of Services Which Have Been Withdrawn During the Period.**

IBT produced a schedule listing 10 items which are "eliminated services/payment options." Am. Ill. Ex. 1.0, Sch. 2. IBT did not indicate which were services, which were payment options, or which applied to the residential, business, carrier or other service category. Therefore, the listing does not help the Commission discern the significance of the

discontinuation of these services.

**7. A Listing of All Services Which Have Been Reclassified as Competitive or Noncompetitive During the Period.**

In his Direct Testimony, IBT witness Gebhardt provided the Commission with a list of services which IBT has reclassified as competitive since the inception of the plan. Am.Ill. Ex. 1.0, Sch. 3. Gebhardt failed to discuss the history of any of these reclassifications in his testimony, however, and the list therefore does not reveal that many of those reclassification have not withstood Commission scrutiny. Compare Am.Ill. Ex. 1.0 at 15-17 with GCI Ex. 1.0 at 27-29 & GCI Ex. 1.5 and City Ex. 1.0 at 28-30 & City Ex. 1.2. The history of these reclassifications, which was not provided in any IBT exhibit, reveals that the Company's decisions to classify certain telecommunications services as competitive has not been smooth or uncontroverted. Major reclassifications have been challenged and/or reversed by the Commission, requiring substantial expenditures of Commission and intervenor resources. See GCI Ex. 1.0 at 27-29, GCI Ex. 1.5; City Ex. 1.0 at 28-30 & City Ex. 1.2.

IBT's listing indicates that some of these reclassifications, including business usage for band B and C calls and operator assisted and calling card usage and usage originating in MSAs 1,2,3,6,7,9 and 15, were reversed in October of 1995, without revealing that the reversal occurred through a Commission order which was later affirmed by the Illinois Appellate Court after extensive, contentious litigation. Illinois Bell Telephone Co. v. Illinois Commerce Commission, 282 Ill.App.3d 672 (3d Dist 1996); See also GCI Ex. 1.5 (Staff Report)(describing litigation history). Further, IBT lists a 1998 reclassification for all business services in Illinois and for residential service in 19 exchanges as competitive. The exhibit does not mention that a Commission-initiated investigation into the propriety of those reclassifications, ICC Docket No.

98-0860, is pending.<sup>5</sup>

A primary result of reclassifying a service as competitive is that it removes the service from the alternative regulation plan. Services classified as competitive are no longer subject to the pricing constraints of the plan, nor are revenues from the services included in the calculation of the service quality adjustment. The reclassifications pursued by IBT during the plan removed about 35% of its revenues from the plan,<sup>6</sup> and left the plan significantly less effective in both retaining the benefits of productivity for consumers and protecting consumers from market abuse. They must be seen as evidence of IBT's intention to dismantle the alternative regulation plan service by service and disengage customers from the protections of that plan.

IBT's disingenuous attempts to classify monopoly services as competitive reveals all too clearly why the alternative regulation plan as currently designed is not providing a smooth transition to a competitive market. By improperly classifying services as competitive, IBT is attempting to avoid even the minimal regulation imposed by the plan. As will be discussed below, the alternative regulation plan needs to be revised to eliminate perverse incentives to prematurely reclassify services as competitive and raise rates unconstrained by competition or the price cap index.

#### **8. A Summary of New Services Which Have Been Introduced During the Period.**

IBT provided a listing of new services offered in each year from 1995 to 1999. Am. III.

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<sup>5</sup> A Hearing Examiner's Proposed Order is expected to be issued soon in this docket.

<sup>6</sup> For example, the service quality adjustment, which was .25% of the revenues subject to the plan, dropped from \$4 million to \$2.6 million over the past 6 1/2 years. GCI Ex. 2.0 at 66.

Ex. 1.0, Sch. 4. However, this listing does not provide sufficient detail for the Commission to draw any conclusions about the nature of the new services or whether the plan has led to more new services than would have been offered in the absence of alternative regulation. The listing fails to provide a description of the services or to indicate whether the new services fall in the business, carrier, residential or other category.

Some of the "new services" merely represent different billing options for existing services. This is true for the 1995 usage discount plans, the 1996 ValueLink offering, the 1997 residence local call plans, and the 1999 Anytime rate calling plan. As GCI witness TerKeurst pointed out, "a bundle of services that are already available to customers on a stand-alone basis is properly labeled as a restructured service because it modifies the method of provisioning and charging for the same services previously available." GCI Ex. 11.0 at 61. "Restructured" services do not represent innovation or an expansion of service options.

#### **9. Information Regarding Any Changes in Universal Service Levels in Illinois Bell's Service Territory During the Price Cap Period.**

Attached to its 1998 Application for Review, IBT included a single page showing that FCC data on Illinois telephone subscribership. That document shows a decline in telephone penetration during the course of the plan from 93.6% in 1994 and 1995 to 92.2% in 1997. Application, Sch. 9. In later testimony, IBT witness David Gebhardt addressed universal service, and admitted that "Illinois' standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data." Am.Ill. Ex. 1.1 at 64.

GCI witness William Dunkel gave more specific universal service information, which demonstrated that in 1999, the last year for which annual information is available, Illinois reached a low point of 91.8% telephone penetration. GCI Ex. 8.0 at 7. Mr. Dunkel also showed

that telephone penetration rates in Illinois have declined during the course of the alternative regulation plan, and that the FCC singled out Illinois as the only state with a “significant decrease” in penetration from 1983 to July, 2000. GCI Ex. 8.0 at 7; GCI Ex. 9.0 at 2 & GCI Ex. 9.1. Mr. Dunkel also showed that Illinois is 2.4% below the national penetration rate, whereas in 1995 it was only .3% away from the national average. GCI Ex. 8.0 at 7 & n. 2.

IBT provides 85% of the access lines in Illinois. GCI Ex. 8.0 at 7, n. 2. Accordingly the Illinois penetration rate shown in FCC data could reasonably be linked to IBT’s penetration rate. Id. The 1.8% decline from 1995 to 1999 substantially exceeds the 1.4% change Mr. Gebhardt admitted was statistically significant, Am. Ill. Ex. 1.1 at 63, and should be a matter of concern to the Commission in this evaluation of alternative regulation.

**10. Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals.**

See section D. below.

**D. Meeting the Statutory Criteria**

Section 13-506.1 of the Public Utilities Act authorizes the Commission to adopt an alternative regulation plan. The statute begins:

Notwithstanding any of the ratemaking provisions of this Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation **in order to establish just and reasonable rates** for noncompetitive telecommunications services ... The Commission is authorized to adopt different forms of regulation to fit the particular characteristics of different telecommunications carriers and their service areas.

13-506.1(a), 220 ILCS 13-506.1(a)(emphasis added).

The statute provides several requirements that must “at a minimum” be met in order for a plan to be approved, 220 ILCS 5/13-506.1(b)(1)-(7), plus certain public policy goals that the

Commission must consider in approving an alternative regulation plan, id. at 13-506.1(a)(1)-(6). The General Assembly also anticipated continued Commission review to insure compliance with the statutory requirements, and possible rescission of the plan “if, after notice and hearing, it finds that the conditions set forth in subsection (b) of this Section can no longer be satisfied.” Id. at 13-506.1(e). The Commission acted consistently with this legislative intent when it ordered IBT to file an application for review of the plan on March 31, 1998 and included in its review whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals. Alt. Reg. Order at 95 & App. at 10-11.

The following discussion demonstrates that the current alternative regulation plan has failed to meet the statutory and regulatory goals established by the legislature and by the Commission, and that it must be rescinded or substantially revised to comply with the law.

#### **1. The Current Alternative Regulation Plan Is Not In The Public Interest.**

Pursuant to Section 13.506.1(b)(1), the Commission must find that any alternative regulation plan is in the public interest. As with all other aspects of Section 13-506.1(b), the Commission must conclude that the alternative regulation plan under consideration is a more appropriate means to accomplish this goal than previously existing regulatory schemes. 220 ILCS 5/13-506.1(b)(4).

Finding that the plan promotes the public interest necessarily encompasses a broad set of criteria. As the Commission noted in its Alt. Reg. Order, this provision “...takes into consideration all of the policies and criteria set forth in response to Sections 13-506.1 (a) (1)-(6), 13-103 and 13-506.1(2) – (7).” Alt. Reg. Order at 191. The rest of the Alt. Reg. Order’s analysis of this provision focuses on IBT’s network investment commitment. That issue is more

thoroughly discussed in this brief below.

The People believe that the more critical question under this provision is whether a plan which does not result in just and reasonable rates can ever be in the public interest. We maintain that it cannot. Indeed, the General Assembly's focus in drafting Section 13-506.1 is to posit alternative forms of regulation in contrast to other ratemaking provisions of the Act, as a way to achieve "just and reasonable rates." 220 ILCS 5.13-506.1(a), (a)(6) & (b)(2). The statutory language grants the Commission authority to establish other forms of regulation for an express purpose: "...to establish just and reasonable rates for noncompetitive services..." 220 ILCS 13-506.1(a).

For this reason, we believe the Commission's public interest finding in this proceeding must determine what method of regulation is most likely to lead to fair, just and reasonable rates. All other analyses which the Commission makes in this case must serve this overriding goal of fair, just and reasonable rates for consumers.

**2. The Alternative Regulation Plan Has Not Resulted in Fair, Just and Reasonable Rates for Non-Competitive or Competitive Services, in Violation of Sections 13-506.1(b)(2) As Well As Sections 13-506.1(a)(6) and 13-103(a) and Other Provisions of the PUA.**

One of the basic premises of the Public Utilities Act and the Universal Telephone Service Protection Law of 1985 is that rates charged by a public utility be "just and reasonable." See 220 ILCS 5/9-101, 9-241 (non-discriminatory rates), 9-250, 13-504, 13-505, 13-506.1, 1-102(d)(viii) (regulatory goals and objectives include that "rates for utility services are affordable and therefore preserve the availability of such services to all citizens."). The prefatory language in the section 506.1 authorizes alternative regulation in order to establish just and reasonable rates and restates the necessity to set just and reasonable rates in three other subsections. 220 ILCS

5/13-506.1(a), 13-506.1(a)(6), 13-506.1(b)(2), 13-103(a). A key question on review of the plan, therefore, is whether the price cap plan has resulted in fair, just and reasonable rates.

The price cap plan was established with the expectation that overall prices would decline provided IBT's productivity or "X" factor, set at 4.3%, continued to exceed inflation. Alt. Reg. Order at 41. Therefore, the fact that some prices decreased as a result of the plan, in and of itself, does not show anything other than that the mechanics of the price cap plan were followed and operated as intended to decrease rates. It does not show, however, whether the resulting rates are "just and reasonable" or how they compare to the rates that would have been expected under rate of return regulation.

The Commission recognized the relevance of rate of return regulation as a touchstone when it compared anticipated price cap rates to rates under rate of return regulation, stating that it was "difficult to reconcile" annual rate increases, which were anticipated under IBT's proposed X factor, "with our determination of just and reasonable rates using traditional ROR regulation analysis." Alt. Reg. Order at 41. The Commission said that yearly increases "would not offer the ratepayer any readily apparent advantage" compared to the stability of rates under ROR regulation. Id.

Considering IBT's rates in light of its revenues and rate base demonstrates that IBT is retaining significantly more revenues under alternative regulation than would be tolerated under rate of return regulation. Even without considering the returns in the years prior to 1999 (see page 12-13 above), the 1999 returns ultimately calculated by IBT's accounting witness showed an overall return on rate base of 18.82%, although IBT's witness previously calculated a return as high as 19.21%. Compare Am.III.Ex. 7.3 at 5 and Am.III. Ex. 7.2 at 37. When appropriate adjustments to IBT's analysis were made by GCI witness Ralph Smith and by Staff witnesses,

IBT's 1999 returns were: 28.49% on intrastate rate base with a 43.08% return on equity. GCI Ex. 6.2 at 3 revised. Staff showed IBT receiving a 26.7% return on intrastate rate base. Staff Ex. 30, Sch. 30.01.<sup>7</sup> These returns are about 2.5 times higher than the overall cost of capital calculated by Staff (10.52%), Staff Ex. 25 at 3, and IBT witness Roger Ibbotson (10.58-11.21%), Am.III. Ex. 6.0, Sch. 13.

These high returns demonstrate that costs have decreased significantly more than rate reductions under the price cap index. City Ex. 1.0 at 39. This mismatch between the price index and actual savings was one concern expressed by the Commission when it adopted the price index. See Alt. Reg. Order at 37, 40 & "Scope of Review" above. The Commission required IBT to report certain financial information during the course of the plan because it believed that financial information would "provide useful evaluative information." Alt. Reg. Order at 92. The Company was required to file, *inter alia*, total company and Illinois jurisdictional rate base, operating revenue and expenses, and return on net utility rate base and total Company return on common equity. *Id.* at 93-04, para. (a), (b), (e). In explaining the reporting requirement, the Commission stated: "unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective." *Id.* at 92.

The returns calculated for 1999 by all parties demonstrate "unusually high reported rates of return". *Id.* The high returns in prior years support the conclusion that the price cap plan was misspecified and has not returned a reasonable portion of cost savings to consumers, contrary to

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<sup>7</sup> This figure is calculated by dividing column (d), line 21 by column (f). Line 23, Staff Ex. 30.0, Sch. 30.01.

Commission expectations. See discussion of just and reasonable rates and designating the X factor going forward, below. These extraordinarily high returns, coupled with the failure of the plan to cause a reduction in NAL rates, the most inelastic and unavoidable charge incurred for telephone service and the substantial increases in rates following reclassification as competitive, demonstrate that the current plan is not producing fair, just and reasonable rates, and cannot lawfully be continued absent revision to the price cap index and the plan as a whole.

In anticipating a growth in competition and the loss of market share by IBT, the Commission expected that market forces would constrain competitive prices and earnings. Alt. Reg. Order at 187. IBT witness William Avera, confirmed that in a competitive market, higher than market returns are not sustainable. He testified that "in a competitive market, as returns get higher, that's a signal to competitors that this is an attractive area. So returns have the effect of inducing entry. ... [Investors] look at the prospects for earnings, knowing that things like competitive entry and economic circumstances will drive future earnings." Tr. 770-771. Mr. Avera further stated on cross-examination:

Q. Would investors perceive a return that is high in their estimation to be a signal that there might be trouble ahead in that a competitor would see a vulnerability there?

A. Yes, I think a competitor — the investors would say is the return sustainable and they know when a company earns high returns because of a temporary competitive advantage or a temporary economic advantage that those returns are not sustainable.

Tr. 771. GCI witness TerKeurst echoed this thought when she stated: "In a competitive market, the existence of multiple providers and competitive alternatives would restrict a carrier's ability to earn such excessive profits. However, such forces are not in play for noncompetitive telecommunications services. As a result, higher-than-expected earnings levels can raise a warning flag that the Commission may need to re-examine the adopted alternative regulation plan with great care and that modifications, including possible revenue adjustments, may be

warranted.” GCI Ex. 1.0 at 11-12

In a competitive market, the returns received by IBT, which are more than double the reasonable, market based cost of capital based on the testimony of IBT witness Roger Ibbotson, Am.Ill. Ex. 6.0, and Staff witness Alan Pregoan, Staff Ex. 11, 25, would not be sustainable. Because competition is not well enough developed for competitors to freely enter the market and constrain IBT’s prices and profits, regulation is still needed to set IBT’s profits and rates at fair, just and reasonable levels. The high returns received by IBT and the large rate increases imposed on “competitive” services, should lead the Commission to conclude that IBT’s rates are not “fair, just and reasonable” as required by law, and that they need to be reinitialized to reasonable levels.

Both non-competitive and competitive rates and revenues should be reinitialized to fair, just and reasonable levels. Although the Public Utilities Act requires that rates for services classified as competitive be just and reasonable, see 220 ILCS 5/13-505(b), the price cap index does not limit rates for those services. 220 ILCS 5/13-506.1(a). Section 13-506.1(b)(4), which incorporates section 13-103(a) into a requirement for alternative regulation, is not limited to non-competitive services rates. That section reads:

[T]elecommunications services should be available to all Illinois citizens at just, reasonable and affordable rates and that such services should be provided as widely and economically as possible, in sufficient variety, quality, quantity and reliability to satisfy the public interest.

220 ILCS 5/13-103(a). The legislature further stated its policy to be that:

Consistent with the protection of consumers of telecommunications services and the furtherance of other public interest goals, competition in all telecommunications service markets should be pursued as a substitute for regulation in determining the variety, quality and price of telecommunications services and that the economic burdens of regulation should be reduced to the extent possible consistent with the furtherance of market competition and protection of the public interest.

220 ILCS 5/13-103(b). In this review of the alternative regulation plan, and whether it has produced fair, just, reasonable and affordable rates, sections 13-506.1(a) and 13-103 (a) and (b) require the Commission to examine whether IBT's reclassification of services as competitive has been consistent with consumer protections and the legislative intent that competition substitute for regulation "to the extent possible consistent with the furtherance of market competition and protection of the public interest." 220 ILCS 5.13-103(b). The substantial increases in rates for services classified as competitive, as discussed more fully below, combined with the excessive profits reported by IBT, demonstrate that it is not yet possible or prudent to substitute competition for the regulation of IBT's rates and revenues.

The evidence demonstrates that the plan has not led to fair, just and reasonable rates because (1) the returns experienced by IBT have been much greater than was reasonably anticipated when the plan was adopted and (2) the Company has abused the PUA's competitive reclassification authority to prematurely remove services from the price index, confident that price increases would lead to increased revenues unconstrained by competition or regulation. These effects demonstrate that the price index plan has not been successful in maintaining just and reasonable rates for Illinois consumers of services classified as non-competitive and competition, and that the Commission must reinitialize rates to just and reasonable levels in order to comply with the law.

**2. The Changes in Technology and Industry Structure Anticipated by the Alternative Regulation Plan Have Not Occurred, and the Plan's Unwarranted Reliance on Those Changes Has Led to Unjust Results.**

The Commission premised its alternative regulation plan on the changes it believed were

occurring in the telecommunications industry, specifically, the development of competition and changing technology. Alt. Reg. Order at 187. A major issue in this docket is whether those changes have actually occurred, and whether the plan has resulted in fair and reasonable responses to these changes as they have in fact occurred.

The legislature required that alternative regulation “respond to changes in technology and the structure of the telecommunications industry that are, in fact, occurring.” 220 ILCS 13-506.1(b)(3). Further, the General Assembly intended that:

Consistent with the protection of consumers of telecommunications services and the furtherance of other public interest goals, competition in all telecommunications service markets should be pursued as a substitute for regulation in determining the variety, quality and price of telecommunications services and that the economic burdens of regulation should be reduced to the extent possible consistent with the furtherance of market competition and the protection of the public interest.

220 ILCS 5/13-103(b). Because competitive changes in the telecommunications industry did not develop as the Commission expected, the plan and the industry are mismatched, causing excessive rates to consumers, excessive earnings for the company, service quality degradation and an inappropriate response to the changes that are “in fact, occurring” in the telecommunications industry.

**a. The Competitive Changes the Commission Anticipated Have Not Occurred.**

The Act requires that an alternative regulation plan respond to changes that are “in fact, occurring.” 220 ILCS 5/13-506.1(b)(3). In approving IBT’s pure price cap plan, the Commission believed that “the market environment which Illinois Bell will be facing in the future will be an increasingly competitive one. Price regulation responds to these changes in the structure of the telecommunications industry.” Alt. Reg. Order at 187. The Commission expected “market forces [to] control competitive prices and earnings,” and that “price regulation